

# HOUSE OF COMMONS

**First Report from the**

## **ENERGY COMMITTEE**

**Session 1983 – 84**

### **ELECTRICITY AND GAS PRICES**

**Volume I**

**Report and Appendices; together with Minutes of  
Proceedings relating to the Report**

---

*Ordered by the House of Commons to be printed  
27 February 1984*

---

**LONDON**  
**HER MAJESTY'S STATIONERY OFFICE**  
£3.75 net



The Select Committee on Energy is appointed under SO No 99 to examine the expenditure, administration and policy of the Department of Energy and associated public bodies, and similar matters within the responsibilities of the Secretary of State for Northern Ireland.

The Committee consists of a maximum of eleven Members, of whom the quorum is three. Unless the House otherwise orders, all Members nominated to the Committee continue to be members of it for the remainder of the Parliament.

The Committee has power:

- (a) to send for persons, papers and records, to sit notwithstanding any adjournment of the House, to adjourn from place to place, and to report from time to time;
- (b) to appoint specialist advisers, either to supply information which is not readily available or to elucidate matters of complexity within the Committee's order of reference;
- (c) to communicate to any other such Committee its evidence and any other documents relating to matters of common interest; and
- (d) to meet concurrently with any other such Committee for the purposes of deliberating, taking evidence, or considering draft reports.

---

The following were nominated as Members of the Committee on 9 December 1983:

Mr Kevin Barron  
Dr Michael Clark  
Mr J D Concannon  
Mr Robert Hayward  
Mr Ted Leadbitter  
Mr Ian Lloyd

Mr Geoffrey Lofthouse  
Mr Gerald Malone  
Mr Michael Morris  
Mr Peter Rost  
Mr Tony Speller

Mr Ian Lloyd was elected Chairman on 19 December 1983.

## NOTES

*In the Report, references to the Minutes of Evidence are indicated by the letter 'Q' followed by the number of the question referred to. References to Memoranda included in the Minutes of Evidence are indicated by the word 'Evidence', followed by the number of the page referred to. References to Memoranda etc included in the Appendices are indicated by the word 'Appendix', followed by the number of the Appendix referred to.*

---

The cost of printing and publishing this Report is estimated by Her Majesty's Stationery Office at £3,300.

The cost of preparing for publication the Shorthand Minutes of Evidence taken before the Committee was £563.30.

## TABLE OF CONTENTS

## Volume I

|                                                               | <i>Page</i> |
|---------------------------------------------------------------|-------------|
| LIST OF WITNESSES ... ..                                      | iv          |
| LIST OF MEMORANDA PRINTED WITH THE MINUTES OF EVIDENCE ... .. | v           |
| LIST OF APPENDICES TO THE MINUTES OF EVIDENCE ...             | vi          |
| GLOSSARY OF ABBREVIATIONS USED IN THE REPORT ...              | vii         |
| CONTENTS OF THE REPORT ... ..                                 | viii        |
| REPORT ... ..                                                 | xi          |
| MINUTES OF PROCEEDINGS RELATING TO THE REPORT ...             | xxxviii     |

## Volume II\*

|                            |     |
|----------------------------|-----|
| MINUTES OF EVIDENCE ... .. | 1   |
| APPENDICES ... ..          | 114 |

\*To be published on 5 March 1984.

## LIST OF WITNESSES

Volume II  
Page*Thursday, 19 January 1984*

## HM TREASURY

|                                                                                |     |     |     |     |     |     |     |     |    |
|--------------------------------------------------------------------------------|-----|-----|-----|-----|-----|-----|-----|-----|----|
| Mr T U Burgner, Mr S A Robson, Mr G A C D Houston (also published as HC 215-i) | ... | ... | ... | ... | ... | ... | ... | ... | 32 |
|--------------------------------------------------------------------------------|-----|-----|-----|-----|-----|-----|-----|-----|----|

*Wednesday, 25 January 1984*

## THE ELECTRICITY COUNCIL AND THE CEBG

|                                                                                                  |     |     |     |     |     |     |     |     |    |
|--------------------------------------------------------------------------------------------------|-----|-----|-----|-----|-----|-----|-----|-----|----|
| Mr T P Jones, CB, Mr F E Bonner, CBE, Mr R W Orson, Mr K F Whittle (also published as HC 215-ii) | ... | ... | ... | ... | ... | ... | ... | ... | 66 |
|--------------------------------------------------------------------------------------------------|-----|-----|-----|-----|-----|-----|-----|-----|----|

*Thursday, 26 January 1984*

## THE BRITISH GAS CORPORATION

|                                                                                |     |     |     |     |     |     |     |     |    |
|--------------------------------------------------------------------------------|-----|-----|-----|-----|-----|-----|-----|-----|----|
| Sir Denis Rooke, Mr W G Jewers, Mr C W Brierley (also published as HC 215-iii) | ... | ... | ... | ... | ... | ... | ... | ... | 84 |
|--------------------------------------------------------------------------------|-----|-----|-----|-----|-----|-----|-----|-----|----|

*Wednesday, 1 February 1984*

## DEPARTMENT OF ENERGY

|                                                                                      |     |     |     |     |     |     |     |     |    |
|--------------------------------------------------------------------------------------|-----|-----|-----|-----|-----|-----|-----|-----|----|
| Rt Hon Peter Walker, MP, Secretary of State for Energy (also published as HC 215-iv) | ... | ... | ... | ... | ... | ... | ... | ... | 99 |
|--------------------------------------------------------------------------------------|-----|-----|-----|-----|-----|-----|-----|-----|----|

# LIST OF MEMORANDA INCLUDED IN THE MINUTES OF EVIDENCE

|                                                                                                                | Volume II   |
|----------------------------------------------------------------------------------------------------------------|-------------|
|                                                                                                                | <i>Page</i> |
| Memorandum submitted by HM Treasury ... ..                                                                     | 1           |
| Memorandum submitted jointly by HM Treasury and the Department<br>of Energy ... ..                             | 2           |
| Memorandum submitted jointly by the Electricity Council and the Central<br>Electricity Generating Board ... .. | 8           |
| Memorandum submitted by the British Gas Corporation ... ..                                                     | 20          |
| Memorandum submitted by the Electricity Consumers' Council... ..                                               | 50          |
| Memorandum submitted by the Chairman of the London Electricity<br>Consultative Council ... ..                  | 57          |
| Memorandum submitted by the National Gas Consumers' Council ...                                                | 80          |

## LIST OF APPENDICES TO THE MINUTES OF EVIDENCE

Volume II  
Page

|                                                                                                                                                 |     |
|-------------------------------------------------------------------------------------------------------------------------------------------------|-----|
| 1. Supplementary Questions to HM Treasury ... ..                                                                                                | 114 |
| 2. Supplementary Replies from HM Treasury ... ..                                                                                                | 115 |
| 3. Note by HM Treasury on the rate of interest payable on money deposited with the Government by Nationalised Industries ... ..                 | 116 |
| 4. Supplementary Memorandum from the Electricity Council ... ..                                                                                 | 117 |
| 5. Letter from the Secretary of the Electricity Council to the Clerk of the Committee. ... ..                                                   | 119 |
| 6. Supplementary Memorandum from the British Gas Corporation ... ..                                                                             | 120 |
| 7. Supplementary Memorandum from the Department of Energy ... ..                                                                                | 123 |
| 8. Supplementary Note from the National Gas Consumers' Council ... ..                                                                           | 124 |
| 9. Correspondence between the Secretary of the Electricity Supply Industry Employees' National Committee and the Clerks to the Committee ... .. | 125 |
| 10. Extract from a Memorandum submitted by the Confederation of British Industry ... ..                                                         | 129 |
| 11. Memorandum from Pilkington Brothers PLC... ..                                                                                               | 135 |
| 12. Memorandum from Calor Gas Northern Ireland Ltd ... ..                                                                                       | 140 |
| 13. Copy of Correspondence between the Association of British Chambers of Commerce and the Secretary of State for Energy ... ..                 | 141 |
| 14. Letter from the Chairman of the John Williams Group of Companies ... ..                                                                     | 144 |
| 15. Memorandum submitted by the Society of British Gas Industries ... ..                                                                        | 145 |

### Glossary of Abbreviations used in the Report

|       |                                           |
|-------|-------------------------------------------|
| BGC:  | British Gas Corporation                   |
| BST:  | Bulk Supply Tariff                        |
| CCA:  | Current Cost Accounting                   |
| CEGB: | Central Electricity Generating Board      |
| DEn:  | Department of Energy                      |
| DHS:  | Deloitte, Haskins and Sells (see para 16) |
| EC:   | Electricity Council                       |
| ECC:  | Electricity Consumers' Council            |
| EFL:  | External Financing Limit (see para 65)    |
| ESI:  | Electricity Supply Industry               |
| FT:   | Financial Target (see para 63)            |
| HC:   | House of Commons Paper                    |
| LEB:  | London Electricity Board                  |
| LECC: | London Electricity Consultative Council   |
| LRMC: | Long Run Marginal Costs (see para 62)     |
| NCB:  | National Coal Board                       |
| NGCC: | National Gas Consumers' Council           |
| PRT:  | Petroleum Revenue Tax                     |
| PSBR: | Public Sector Borrowing Requirement       |

## CONTENTS OF THE REPORT

|                                                                                                                          |  |                   |
|--------------------------------------------------------------------------------------------------------------------------|--|-------------------|
| <i>Section I: Introduction</i>                                                                                           |  | <i>Paragraphs</i> |
| (i) Background to the Enquiry ... ..                                                                                     |  | 1-5               |
| (ii) Reasons for the Enquiry ... ..                                                                                      |  | 6                 |
| (iii) The Purpose of the Enquiry ... ..                                                                                  |  | 7-8               |
| (iv) The Framework of Financial Controls ... ..                                                                          |  | 9                 |
| (v) Framework of Analysis ... ..                                                                                         |  | 10-12             |
| <br><i>Section II: The Gas Price Increase from 1st January 1984</i>                                                      |  |                   |
| (i) Brief History of Recent Gas Price Increases ... ..                                                                   |  | 13-14             |
| (ii) Brief Narrative of Events Leading to the Gas Price Increase ... ..                                                  |  | 15                |
| (iii) Evidence from the British Gas Corporation ... ..                                                                   |  | 16                |
| (iv) Evidence from the Department of Energy and HM Treasury ... ..                                                       |  | 17                |
| (v) Evidence from the NGCC ... ..                                                                                        |  | 18-19             |
| (vi) Conclusions on the Gas Price Increase ... ..                                                                        |  | 20-25             |
| <br><i>Section III: The Proposed Electricity Price Increase</i>                                                          |  |                   |
| (i) Brief History of Electricity Price Increases Over Recent Years ... ..                                                |  | 26                |
| (ii) Brief Narrative of Events Leading to the Proposed Electricity Price Increase ... ..                                 |  | 27-31             |
| (iii) Evidence from HM Treasury ... ..                                                                                   |  | 32-34             |
| (iv) Evidence from EC/CEGB ... ..                                                                                        |  | 35-36             |
| (v) Evidence from the Consumers' Organisations ... ..                                                                    |  | 37-38             |
| (vi) Evidence from the Secretary of State for Energy ... ..                                                              |  | 39-40             |
| (vii) Conclusions on the Proposed Electricity Price Increase ... ..                                                      |  | 41-53             |
| <br><i>Section IV: The Implications for the Future:</i>                                                                  |  |                   |
| <i>The Financial and Consultative Framework for the Gas and Electricity Industries</i>                                   |  |                   |
| (i) The Financial Target ... ..                                                                                          |  | 55                |
| (ii) Performance Objectives ... ..                                                                                       |  | 56                |
| (iii) The External Financing Limit ... ..                                                                                |  | 57                |
| (iv) Pricing Policy ... ..                                                                                               |  | 58                |
| (v) The Role of the Consumers' Organisations ... ..                                                                      |  | 59                |
| (vi) The Need for a Coherent Statement of Government Policy towards the Nationalised Energy Industries ... ..            |  | 60                |
| <br><i>Appendix A: The Framework of Financial Controls</i>                                                               |  |                   |
| (i) The Evolution of Statutory and Other Controls ... ..                                                                 |  | 61                |
| (ii) The Constituent Parts of the Framework ... ..                                                                       |  | 62-65             |
| <br><i>Appendix B: The Comparative Capital Debt Positions and Cost Projections of the Gas and Electricity Industries</i> |  |                   |
| (i) The Gas Industry ... ..                                                                                              |  | 66-67             |
| (ii) The Electricity Supply Industry ... ..                                                                              |  | 68-71             |

THE FOLLOWING ARE OUR PRINCIPAL CONCLUSIONS AND RECOMMENDATIONS:—

*The Gas Price Increase from 1st January 1984*

(i) The Committee has been presented with no evidence to suggest that the recently announced gas price increase conflicts with the commercial judgment of the industry. (see para 21)

(ii) We see no grounds seriously to question the BGC's expectation that over the next two to three years domestic and industrial tariffs might rise in line with the prevailing rate of inflation. (see para 22)

(iii) Further evidence would need to be provided before the Committee could be convinced that the Corporation's current Performance Objective is sufficiently demanding to produce maximum efficiencies. (see para 23)

(iv) As far as the role of the consumers' organisations is concerned, we share the NGCC's anxiety that the statutory consultation procedures should begin early enough and with the provision of sufficient information for a view to be expressed before the industry's pricing decisions are irrevocably formed. In this respect, it was particularly unsatisfactory that the industry's Financial Target for the period 1983-84 to 1986-87 was not announced until nearly nine months into the first financial year. (see para 24)

*The Proposed Electricity Price Increase from 1st April 1984*

(v) Neither in terms of the need for the industry to meet its Financial Target, nor on the basis of the Government's policy of economic pricing for electricity, are we persuaded by the case for a 2 per cent price increase on 1 April 1984. (see para 45)

(vi) We find the whole process by which the ESI's EFL for 1984-85 was set, quite apart from the figure itself, extremely disturbing, since it appears to have almost completely inverted the normal procedure. (see para 46)

(vii) The Electricity Council was asking for no more than to be allowed to see how the industry's financial position developed during the course of the year before deciding what action might be required to meet its EFL. We find it quite extraordinary that the Government were unwilling to accept this sensible suggestion. (see para 47)

(viii) The effect of the Government's action is retrograde in terms of general policy towards the nationalised industries since it obliges the electricity industry, against its own better judgment, to adopt the pricing policy of an unfettered monopoly producer, when the Government's declared aim is to restrain costs by introducing a greater element of competition into the energy market through such measures as the Energy Act 1983. (see para 48)

(ix) We cannot avoid the conclusion that the only plausible motivation for the large increase in the ESI's negative EFL for 1984-85 (which has led directly to the decision to recommend a 2 per cent price increase from 1st April) was the

Government's wish, on grounds of macro-economic policy, to raise additional revenue in order to reduce the Public Sector Borrowing Requirement. (see para 49)

(x) We recommend that the Government and the electricity industry publish a joint response to the legal aspects of the LECC's submission to this Committee. (see para 52)

#### *The Role of the Consumers' Organisations*

(xi) Consumers' organisations must not be placed in the position of having to react to a fait accompli. They should be invited to give their comments on proposed price increases at a sufficiently early stage to have some genuine chance of influencing the outcome. Moreover, if the spirit as well as the letter of the consultation process is to be fulfilled, consumers' organisations must have access to the maximum relevant information to enable them to reach a considered judgment. (see para 59)

#### *The Financial Framework of the Nationalised Energy Industries*

(xii) We believe, in view of the confusion and inconsistencies in the application of the financial framework\* to the industries which have emerged during the evidence on the gas and electricity price increases, that there is an urgent need for the Government to clarify its policy in this area. This should preferably take the form of a reaffirmation in comprehensible layman's language, of the principles set out in the 1978 White Paper. (see para 60)

[\*our detailed comments on the financial framework of the gas and electricity industries are at paragraphs 54 to 58].

# FIRST REPORT

*The Select Committee on Energy have agreed to the following Report:*

## ELECTRICITY AND GAS PRICES

### I: BACKGROUND TO THE REPORT

#### (i) Introduction

1. On 17 November 1983 the Chancellor of the Exchequer presented his Autumn Statement to the House in which he announced the External Financing Limits (EFL's) for 1984-85. These were: for the electricity supply industry, minus £740 million (compared with minus £418 million in 1983-84); and for the British Gas Corporation, minus £100 million (compared with minus £43 million in 1983-84).<sup>1</sup> In the context of the Chancellor's announcement of new EFL's, and in the light of public and Parliamentary disquiet about their immediate implications for electricity and gas pricing decisions, the Select Committee on Energy agreed on 19 December 1983 to conduct an urgent enquiry into the proposed tariff increases for 1984.

2. On the same day, the Secretary of State for Energy said in reply to a question in the House: "The gas industry will be announcing its price increases shortly. It will be a decision wholly for the gas industry, without pressure of any description by the Government . . . . The Cabinet has asked the Electricity Council to reconsider its proposals on domestic electricity prices for the next two years. We are talking about the possibility of a two per cent increase next year . . ."<sup>2</sup> On 21 December 1983 the British Gas Corporation announced tariff increases equivalent to an average 4.3 per cent rise for domestic consumers,<sup>3</sup> to take effect from 1 January 1984.<sup>4</sup> On 19 January 1984 the Electricity Council decided to recommend to its Area Boards a two per cent increase in quarterly tariffs for domestic consumers, with effect from 1 April 1984.<sup>5</sup>

3. Although the proposed electricity price increase does not apply directly to Northern Ireland, it has considerable implications for the Province. It has been the policy of successive Governments to provide a subsidy, whether direct or indirect, to electricity users in Northern Ireland. Under the Electricity Service (Finance) (Northern Ireland) Order 1977, accumulated debts of £250 million were written off and subsequent annual payments were made to cover operating losses and to compensate for price restraint. Since 1981, however, electricity tariffs in Northern Ireland have been held down to the level of the highest rate charged by any Area Board in the rest of the UK, which means, at present, that of the London Electricity Board. The subsidy required to maintain this policy is currently running at more than £60 million a year.

<sup>1</sup> For an explanation of negative External Financing Limits, see Appendix A to this Report.

<sup>2</sup> Official Report, 19 December 1983, c.5.

<sup>3</sup> The increase in gas prices is 1.7 pence per therm (5.0 per cent); for the average domestic consumer this represents a 4.3 per cent increase in bills, including the standing charge.

<sup>4</sup> The increase for gas applies to the BGC and relates to gas supplies in Great Britain, i.e. excluding Northern Ireland.

<sup>5</sup> The increase for electricity applies to the ESI in England and Wales only. The ESI comprises the Electricity Council, the CEGB and the 12 Area Electricity Boards. For an account of the situation in Northern Ireland, see Appendix 12.

4. The long delay between the opening of Parliament on 22 June 1983 and the nomination of the Committee on 9 December 1983 has forced an even tighter time-scale on this enquiry than would otherwise have been necessary. Consequently, we must thank all the witnesses for responding at such short notice to the demands placed upon them. Written and oral evidence was taken from the Treasury, the Electricity Council and the CEGB, the British Gas Corporation, and the Secretary of State for Energy. Written evidence was submitted by the various consumers' organisations and others.<sup>6</sup> Unfortunately, because certain witnesses were less helpful and forthcoming than others, our enquiry has to an extent been hampered by the absence of some important and relevant information. We deal with this in more detail in paragraphs 39 and 49.

5. During this enquiry the Committee has drawn upon the specialist advice of Mr John Chesshire and Mr John Surrey, both of the Science Policy Research Unit at the University of Sussex.

#### (ii) *The Reasons for the Enquiry*

6. It was the announcement of the substantial increases in the negative External Financing Limits for the two industries (133 per cent for gas, 77 per cent for electricity) which provided the initial impetus for this enquiry. However, the Committee also took note of the considerable public disquiet about the nature of the role played by the Government, and in particular by the Treasury, in the current round of pricing decisions in those industries, both of which are already making substantial operating profits.<sup>7</sup> There was a widespread concern that this intervention would force the electricity supply industry to raise tariffs from 1 April 1984, despite indications that this move would conflict with their own commercial judgment about the size and timing of any such increase. Although there has been less public controversy surrounding the announcement of tariff increases by the BGC, the Committee also resolved to take evidence on this decision. The financial frameworks within which the two industries operate are closely related,<sup>8</sup> and contrasts and comparisons can be made between both which serve to illuminate each.<sup>9</sup>

#### (iii) *The Purpose of the Enquiry*

7. The Committee has not in this Report concerned itself with the merits of the precise size of either price increase. We have *not* attempted to substitute our own judgments for the commercial judgment of either industry. Indeed, for the purposes of this enquiry it is the role of the Government, not the actual size of the increases, that is relevant. Even if these had been considerably larger, or zero, the same questions would still have needed to be asked. These questions are as follows:

- (i) Did these pricing decisions result from the application of a lucid and rational set of principles, understood and agreed to by all the parties concerned?

<sup>6</sup> For a complete list of evidence and witnesses, see pp. iv-vi.

<sup>7</sup> For the ESI, the operating profit in 1982-83 was £868 million, an increase of 85 per cent over the preceding year. For the British Gas Corporation the figure for 1982-83 was £663 million, compared with £311 million in 1981-82.

<sup>8</sup> See for example para 5 of the Note by HM Treasury entitled "The Financial Framework for Nationalised Industries", submitted to the Treasury and Civil Service Committee (HC (1980-81) 18, Evidence, p 44).

<sup>9</sup> See Appendix B to this Report.

- (ii) Is the evidence on which these decisions were based both accessible and reasonably comprehensible to a consumer who might wish to discover the explanation for the rise in prices?
- (iii) Were the decisions in conformity with the statutory duties placed upon the industries?
- (iv) Were the decisions consistent with the financial framework set for each industry?
- (v) Are the proposed price increases based upon sound commercial judgments made by the people statutorily charged with the responsibility for such judgments?
- (vi) Did the decisions result from a reasonable degree of consensus among all the interested parties?
- (vii) Did any one view on pricing prevail over others?
- (viii) Was the treatment of the two industries by the Government even-handed?

8. This Report is not directly concerned with the implications of energy price rises for industrial competitiveness, which were covered in our predecessors' 1981 Report.<sup>10</sup> Nevertheless, during our current enquiry, much evidence has been submitted on this issue,<sup>11</sup> showing the strong feelings which continue to be aroused. As far as the two industries covered in this Report are concerned, we note that there was no significant concern over comparative gas prices, and that anxiety was largely focussed upon variations in prices for large load and/or high load factor industrial consumers of electricity. The conclusions about the way in which decisions were reached on domestic prices are, however, broadly applicable to industrial tariffs and the implications for the future relationship between Government and the nationalised industries are equally relevant.

(iv) *The Framework of Financial Controls*

9. Any examination of energy prices must take account of the complex framework of statutory and other controls which have evolved since nationalisation. These are principally contained in the various Acts of Parliament from 1947 to 1983, and the White Papers of 1961, 1967 and 1978. The constituent parts of the framework are:

- (i) Long Run Marginal Cost Pricing,
- (ii) Financial Targets,
- (iii) Performance Objectives, and
- (iv) External Financing Limits (previously Cash Limits).

A detailed explanation of these constituent parts of the framework and their inter-relationship is given in Appendix A to this Report.

(v) *Framework of Analysis*

10. It will be clear from the preceding paragraph, and the details set out in Appendix A, that a multiplicity of statutory and non-statutory controls, policy statements and policy instruments has developed over the past twenty years.

<sup>10</sup> HC (1980-81) 422.

<sup>11</sup> See Appendices 10 to 15.

The result of the failure of successive Governments over recent years to apply the framework consistently has been to make more difficult the task of assigning responsibility for specific actions and events to particular organisations and individuals, and thus to diminish the likelihood of being able to call them to account to Parliament and the public for the efficient and effective use of publicly owned assets. Moreover, it has tended to diminish the Department of Energy's ability to promote those policies and actions which are most likely to produce measurable improvements in efficiency and effectiveness.

11. An important task for the Committee has been to attempt to disentangle the constituent parts of the process which culminated in the decisions that formed the starting point of this enquiry. This, we believe, must be a preliminary to offering suggestions for changes and improvements. It should be expected that, between the Treasury, the Department of Energy, the gas and electricity supply industries, and the consumers, differences will emerge. Clashes of priorities, different perceptions of time scales, incompatibility of objectives and different styles of decision making are inevitable. It is, as a consequence, more than ever important to discover whether there are clearly defined responsibilities for each constituent organisation involved in the process of decision making, and if firmly drawn lines of command can be shown to exist. Accordingly, we have sought to establish whether these separate roles have been agreed and adhered to, in the interests of promoting the sound commercial management of the nationalised energy industries.

12. There are significant differences between the gas and electricity industries, particularly in terms of their present and prospective cost structures and their capital debt positions. **These are described in detail in Appendix B to this Report.** Partly as a result of these differences between the two industries, their dealings with Government over the current price increases require separate consideration. In Section II, we address the less controversial questions raised in relation to the gas industry, and in Section III we deal with the more complex problem of the proposed electricity price increase.

## *II: THE GAS PRICE INCREASE FROM 1st JANUARY 1984*

### *(i) Brief History of Recent Gas Price Increases*

13. Domestic gas tariffs, which cover the great bulk of all tariff consumers,<sup>12</sup> were increased by 8 per cent in June 1979, 17 per cent in April 1980, 10 per cent in October 1980, 15 per cent in April 1981, 10 per cent in October 1981, 12 per cent in April 1982, 12 per cent in October 1982 and 4.3 per cent in January 1984.<sup>13</sup> Thus, over the period May 1979 to January 1984 domestic tariffs rose by 130 per cent. The picture for industrial consumers is somewhat different and more complex, given the distinction between "firm" and "interruptible" supplies. To assist comparison, Table 1 shows the pattern of average domestic and average industrial prices since 1977-78; it must be borne in mind, however, that the figures include standing charges and different tariff categories.<sup>14</sup>

<sup>12</sup> See Appendix 6, para 6.

<sup>13</sup> Evidence, pp 21 et seq.

<sup>14</sup> Evidence, p 22.

Table 1

*Average Industrial and Domestic Gas Prices, 1977-78 to 1983-84*

|                    | Domestic Consumers |                                  | Industrial Consumers |                                  | Ratio of domestic to industrial |
|--------------------|--------------------|----------------------------------|----------------------|----------------------------------|---------------------------------|
|                    | <i>p/therm</i>     | <i>Increase on previous year</i> | <i>p/therm</i>       | <i>Increase on previous year</i> |                                 |
| 1977-78            | 18.5               | —                                | 9.7                  | —                                | 1.91                            |
| 1978-79            | 18.5               | 0                                | 11.9                 | 22.7% <sub>a</sub>               | 1.55                            |
| 1979-80            | 19.5               | 5.4% <sub>a</sub>                | 14.1                 | 18.5% <sub>a</sub>               | 1.38                            |
| 1980-81            | 24.2               | 24.1% <sub>a</sub>               | 18.8                 | 33.3% <sub>a</sub>               | 1.29                            |
| 1981-82            | 30.4               | 25.6% <sub>a</sub>               | 21.7                 | 15.4% <sub>a</sub>               | 1.40                            |
| 1982-83            | 37.9               | 24.7% <sub>a</sub>               | 23.3                 | 7.4% <sub>a</sub>                | 1.63                            |
| 1983-84 (estimate) | 39.6               | 4.5% <sub>a</sub>                | 24.3                 | 4.3% <sub>a</sub>                | 1.63                            |

Source: *Department of Energy Memorandum* (based on BGC Annual Reports and Accounts), para 21 (Evidence, p 6.).

14. Having previously been subject to price restraint through the Price Commission, gas prices in mid-1979 were judged to be below the level commensurate with LRMC and that which would produce a "reasonable" return on capital. Moreover, in the late 1970s, following the Iranian revolution, the BGC was faced with an upsurge of demand (as consumers switched from oil to gas) of such proportions that it feared it could not meet the peak demand. In January 1980, the Government, with the approval of Parliament introduced two measures which substantially increased the price of gas—as well as raising both the industry's return on capital and its payments to the Treasury. One of the measures was the Gas Levy, which is a tax on gas supplied from fields which were producing before the Petroleum Revenue Tax (PRT) was introduced in 1976. The Government has argued that this Levy performs the same function as PRT in relation to the later oil and gas discoveries in that it is designed to capture the economic rent on these fields.<sup>15</sup> The other measure was the decision that gas prices should be raised by 10 per cent a year in real terms over the three years 1980-81 to 1982-83 (ie 33 per cent above the rate of inflation by the end of the three year period). At the same time the prices which the BGC was having to pay under new North Sea contracts were rising sharply due to international market pressures; for example, the cost of supplies from the Norwegian Frigg field is 24p/therm, 7p/therm above the average cost (including tax and Gas Levy) of supplies from all sources.<sup>16</sup> Against a background of anxieties over the competitive position of British industry, contract prices (predominantly to industrial users) have been held constant since April 1982; to compensate the BGC for the financial effects of accepting the "freeze" in contract prices, the Government reduced the Gas Levy from 1 April 1982 from 5p/therm to 4p/therm.<sup>17</sup> At the Government's instigation the BGC also introduced experimentally a scheme which limits the standing charge to no more than half of any tariff consumer's bill; the cost of this scheme to the BGC is above £20 million a year.<sup>18</sup> Thus, the steep increases in gas prices in recent years have resulted partly from increases in costs, especially those beyond the control of BGC, and partly from a series of Government interventions. The size of the BGC's payments to the Exchequer in respect of the Gas Levy and taxation since 1979-80 are shown in Table 2.

<sup>15</sup> Sir Denis Rooke expressed some disagreement with this view (Q171). See also Appendix 13(ii).

<sup>16</sup> Evidence, p 27.

<sup>17</sup> Evidence, p 23. In passing, the Committee would draw attention to this evidence of the Government's willingness in this case to recognise the cost consequences of taxation and make adjustments on policy grounds.

<sup>18</sup> Evidence, p 21. The source of the details in this paragraph is the written evidence of the Department of Energy and BGC.

Table 2

*BGC Payments to the Exchequer in respect of the Gas Levy and Taxation*

|         | <i>£million (at current prices)</i> |                 |              |
|---------|-------------------------------------|-----------------|--------------|
|         | <i>Gas Levy</i>                     | <i>Taxation</i> | <i>Total</i> |
| 1979-80 | —                                   | 247             | 247          |
| 1980-81 | 129*                                | 227             | 356          |
| 1981-82 | 394*                                | 191             | 585          |
| 1982-83 | 524*                                | 208             | 732          |

\* Figures at constant 1982-83 prices would be £152 million, £425 million and £524 million, respectively.

Source: *BGC Memorandum*.

Note: For further details of the total BGC payments to the Exchequer, see BGC Annual Report and Accounts, 1982-83. p 41.

### (ii) *Brief Narrative of Events leading to the Gas Price Increase*

15. The BGC submitted its Corporate Plan to the Government in the Spring of 1983 and, in the ensuing discussions as part of the Government's annual review of public sector investment and expenditure, sought approval for a framework of controls in which the various elements were mutually consistent. The BGC originally envisaged introducing a price increase of 10 per cent in October 1983; but it did not do so because of unexpected cost savings (around £100 million) and because it was unwilling to commit itself before the Government had set the medium-term Financial Target. The latter was not announced by the Secretary of State until 19 December 1983—almost nine months into the first of the three financial years to which it applies. On 21 December 1983 the BGC announced that tariffs would be increased from 1 January 1984 by 1.7p/therm (a 5 per cent increase in the price of gas and equivalent to an average increase of 4.3 per cent to domestic consumers when the standing charge is included). Over a full year, the price rise is expected to increase BGC revenue by £190 million.<sup>19</sup> In addition, contract gas prices for industrial and larger commercial users taking more than 25,000 therms per year will rise by around 2 per cent with effect from 1 April 1984—thus ending the two year price freeze for these consumers.

### (iii) *Evidence from the British Gas Corporation*

16. There was apparently complete agreement between the BGC and the Government over the price rise from 1 January and the size of the EFL for 1984-85. Sir Denis Rooke, the Chairman of BGC, went to considerable lengths to emphasise his satisfaction with the outcome of negotiations with the Government. The BGC, in contrast to the Electricity Council, had "got what it wanted" (Q167 and Q189). However, one factor that very clearly emerged from all the evidence submitted on gas prices was the scepticism felt by BGC about the usefulness of LRMC as a pricing tool<sup>20</sup> (Q178). The BGC seem to use this concept largely as a reference point for ensuring that pricing decisions based on various other commercial and economic considerations are not significantly out of line with future cost expectations (Q179). The BGC's scepticism was clearly shared by the National Gas Consumers' Council (NGCC)<sup>21</sup> and to some extent supported by the Department of Energy.<sup>22</sup> Nevertheless, the Corporation generally

<sup>19</sup> See Appendix 6, para 7.

<sup>20</sup> Evidence p 26 et seq.

<sup>21</sup> Evidence p 81.

<sup>22</sup> Evidence p 3 et seq.

accepted that projections used in calculating LRMC's have to take some account of the fact (as outlined in Appendix B) that the cost of gas under new contracts has been rising and may rise further in the future, although it was stressed that the actual scale of increase cannot be predicted with any certainty.<sup>23</sup> Some measure of the large margins of tolerance involved here is shown by the BGC's own calculations. These indicate that the minimum price that could be said to lie within the "wide bracket" of LRMC (Q179) is some 15 per cent less than the maximum, as defined in the Deloitte, Haskins and Sells (DHS) Report.<sup>24</sup> This is not all that different from the maximum range of 20 per cent quoted for electricity in the EC/CEGB Supplementary Memorandum.<sup>25</sup>

(iv) *Evidence from the Department of Energy and HM Treasury*

17. The Department's memorandum underlined most of the points made by the BGC in their submission, and echoed Sir Denis Rooke's expressions of mutual satisfaction.<sup>26</sup> It indicated that the conclusions of the Deloitte, Haskins and Sells efficiency study have been incorporated in the new Financial Target and Performance Objective announced for the industry on 19 December 1983. The Treasury claimed that the Financial Target could not be set until the Government had fully considered the report by DHS. However, the Chairman of the BGC stated that he would have preferred to have had an interim financial package agreed before the start of the financial year and, if necessary, to have had the package modified in the light of the Government's consideration of the report (Q163).

(v) *Evidence from the National Gas Consumers' Council*

18. Although expressing several reservations in their memorandum, the NGCC subsequently accepted the increase proposed by BGC.<sup>27</sup> The BGC said that it had consulted the NGCC in advance of the price rise and that they were in broad agreement on the need for it (Q162); however, in its memorandum, the NGCC stated that "... it is clear that successive governments have effectively set the price of gas—at least domestic tariffs—over a period of many years. Prices have been set less by the needs of the industry than by the political goals of the Government of the day." The NGCC opposed the October 1983 price increase proposed by the BGC on the grounds that the industry's large profits made this unacceptable; they added that no-one seemed able to define, let alone quantify, long-run marginal costs. Nevertheless, they accepted that "even allowing for significant improvements in the Corporation's non-gas costs, a significant real increase in prime material costs ... must eventually be reflected in consumers' bills". However, the long list of questions included in their memorandum implies that they had not established a satisfactory basis on which to judge the need (or otherwise) for the price rise which took effect on 1 January 1984.

<sup>23</sup> See Appendix 6, para 3.

<sup>24</sup> See Appendix 6, para 3. (The Deloitte, Haskins and Sells Report was the product of a study of the Corporation's costs and efficiency, commissioned jointly in 1983 by the Department of Energy and the BGC; it has been published.)

<sup>25</sup> See Appendix 4, para 1.

<sup>26</sup> Evidence, p 5.

<sup>27</sup> See Appendix 8 for the NGCC's detailed account of the terms on which they accepted the price increase.

19. The tone of the NGCC's evidence might best be summed up in their sentence: "We do not believe that there is a compelling case for insisting that domestic gas prices move in parallel with those of competing fuels, though we accept that a wide price gap could not be sustained over a long period."<sup>28</sup> They do, however, draw attention to the considerable revenue that is indirectly collected from gas consumers by the Exchequer through the levy and tax. They also remark upon "An 'extraordinary item' of £295 million [which] was taken out of the profit figure [for 1982-83] to allow for the sale without compensation of the Corporation's oil interests".<sup>29</sup> They further question the use of only Current Cost Accounting for the BGC's accounts and assert that on an historic cost accounting basis the Corporation's profits in the three years 1978-80 would have on average been shown as 45 per cent higher than they were on a CCA basis. So far as its own role is concerned, the NGCC, like the ECC, is anxious that the statutory consultation procedures should begin early enough and with the provision of sufficient information to enable them to offer a view before the industry's decisions are irrevocably formed. It also sets out a programme for its own role in monitoring the efficiency and effectiveness of BGC.

(vi) *Conclusions on the Gas Price Increase*

20. The Treasury propounded the philosophy that energy prices should represent "neither a subsidy nor a tax" (Q8). However, as both the BGC and the NGCC stressed in their submissions, the gas industry makes a large contribution to the exchequer through the levy and other taxes. The BGC memorandum shows that over the last four financial years this contribution has totalled £1,920 million.<sup>30</sup> **This is a sizeable element of the BGC's costs which must be passed on to consumers.** It may be considered analogous to taxes on petroleum products, which have long been accepted as a legitimate means of raising revenue (although petroleum supply is not a nationalised monopoly). The Committee understands why the Treasury rejects (Q79, Q80) the BGC's suggestion for the "EFL to be shown pre-tax and pre-levy so that more recognition is given to the Corporation's contribution in reducing the PSBR..."<sup>31</sup> since such a move would tend to destroy the carefully maintained semantic distinctions between negative EFLs, the gas levy and Petroleum Revenue Tax. Such distinctions in our view seldom mean very much to the consumer.

21. **The Committee has been presented with no evidence to suggest that the recently announced gas price increase conflicts with the commercial judgment of the industry.** Nor is there any indication that any of the four parties<sup>32</sup> to the process of reaching this decision are dissatisfied with the outcome. We welcome the firm declaration by the Chairman of the Corporation of his determination to stand by the industry's commercial judgment in determining tariff increases, although we note that in the very recent past the Corporation has several times had to submit to Government intervention in this area.

22. **Given the wide range of uncertainties involved, we share the scepticism of the BGC and other witnesses about the usefulness of LRMC as a pricing yardstick for gas.** It seems clear, as indicated in the BGC's evidence, that some rise in costs is inevitable as relatively cheap gas from early North Sea contracts is

<sup>28</sup> Evidence p 80.

<sup>29</sup> Evidence p 81.

<sup>30</sup> Evidence, p 23.

<sup>31</sup> Evidence, p 23.

<sup>32</sup> ie. The Treasury, Department of Energy, BGC and NGCC.

replaced by more expensive supplies (both from new contracts and from later discoveries by the Corporation in less hospitable areas). We also note, however, that Sir Denis Rooke does not expect all future contract supplies to be as expensive as those from the Norwegian Frigg field. **Since it makes sense for these reasonable future cost assumptions to be reflected, at least in part, in present prices, we see no grounds seriously to question the BGC's expectation that over the next two to three years domestic and industrial tariffs might rise in line with the prevailing rate of inflation.** On the other hand, the BGC's assumption of modest real increases in the longer term is surrounded by much greater uncertainties. These considerations have to be balanced against the danger that by making too generous an allowance for rising gas costs in advance, the Corporation may weaken the downward pressure on its non-gas costs, which will inevitably have to make an increasingly important contribution towards improvements in the industry's overall efficiency, and hence towards restraining prices.

23. **Further evidence would need to be provided before the Committee could be convinced that the Corporation's current Performance Objective is sufficiently demanding to produce maximum efficiencies.** Such detailed evidence is beyond the scope of this enquiry, though we may wish to return to the subject at a later date. The more information the Corporation can provide on its efforts to reduce costs and increase efficiency (for example, a detailed corporate plan, as well as annual demand forecasts and future cost estimates), the better equipped it will be to resist pressures, not least from Government, for an in-depth investigation of the entire industry, of the type carried out by the Monopolies and Mergers Commission. (We do not agree with the Chairman of the Corporation (Q207) that the Deloitte, Haskins and Sells study, which was commissioned jointly by the BGC and the Department of Energy, could be regarded as a satisfactory substitute.)

24. As far as the role of the consumers' organisations is concerned, **we share the NGCC's anxiety that the statutory consultation procedures should begin early enough and with the provision of sufficient information for a view to be expressed before the industry's pricing decisions are irrevocably formed.** In this respect, it was particularly unsatisfactory that the industry's Financial Target for the period 1983-84 to 1986-87 was not announced until nearly nine months into the first financial year. This left insufficient time for adequate consultation with the NGCC—indeed the price increase was formally promulgated only two days after the publication of the Financial Target. We are not convinced that the explanation offered by the Treasury for this delay (Q42) is satisfactory. The NGCC's memorandum propounds a programme for its own role in monitoring the efficiency and effectiveness of BGC, and **the Committee recommends that the Corporation discuss with the NGCC suitable means of implementing these proposals.**

25. There is one further proposition in relation to the gas price increase which deserves comment, although it has been advanced rather more strongly in the case of electricity. Although we agree, as do the NGCC, that "the right signals" about the likely future costs of gas should be given to consumers, we are rather more sceptical about the "smoothing" argument (ie that a number of small price increases should be made at regular intervals to prevent sudden large jumps). This contention seems to us to be valid only when very large increases are expected. However, **we have received no evidence which suggests that substantial rises in real terms in the price of gas are to be expected in the short term.**

### III: THE PROPOSED ELECTRICITY PRICE INCREASE FROM 1 APRIL 1984

#### (i) A Brief History of Electricity Price Increases over Recent Years

26. Between January 1974 and March 1983, electricity prices increased by some 400 per cent in money terms (or some 50 per cent in real terms).<sup>33</sup> Fuel costs represent half of the ESI's total costs, the fuel mix in 1982-83 comprising coal 81 per cent, oil 6 per cent, and nuclear 13 per cent. The costs incurred by the CEBG in generating bulk supplies of electricity are reflected in the Bulk Supply Tariff (BST), representing some 80 per cent of the costs of the 12 Area Electricity Boards which fix retail tariffs for domestic, commercial and industrial consumers.<sup>34</sup> Prior to 1979, electricity price increases were subject to agreement by the Price Commission and, to reflect rapid escalation in fossil fuel input costs, two tariff increases were necessary in 1979 and 1980 (see Table 3). As a result of over-estimation of fuel costs by the ESI, and strong pressure from the Electricity Consumers' Council (ECC), domestic consumers received a rebate on bills in early 1982. Subsequent developments are described in the following paragraphs.

TABLE 3

*Electricity Price Changes 1978-84*

| <i>Date of Revision</i>  | <i>% Changes over Price at Previous Date<br/>including fuel cost (or price) adjustment</i> |                   |
|--------------------------|--------------------------------------------------------------------------------------------|-------------------|
|                          | <i>Domestic</i>                                                                            | <i>Industrial</i> |
| April 1978               | 9.9                                                                                        | 11.5              |
| April/June 1979          | 8.7 (June)                                                                                 | 4.4 (April)       |
| September 1979           | 8.4                                                                                        | 10.9              |
| April 1980               | 17.6                                                                                       | 19.4              |
| August 1980              | 10.3                                                                                       | 1.6               |
| April 1981               | 11.0 (a)                                                                                   | 14.7              |
| April 1982               | 9.0                                                                                        | 9.0               |
| Early 1983               | -0.2 (b)                                                                                   | —                 |
| April 1983               | zero                                                                                       | zero              |
| April 1984 (recommended) | 2.0                                                                                        | zero (c)          |

#### *Notes:*

- (a) 0.34p/kWh rebated on bills rendered January-March 1982. Equivalent to an 8.5 per cent increase overall.
- (b) Standing charges reduced for very small consumers on bills rendered from January/February 1983 covering period from October/November 1982 onwards.
- (c) After fuel price adjustment the increase is expected to be 2.0 per cent. EC Memorandum, para 3.

*Source:* Electricity Council/CEGB Memorandum. Appendix II. (Evidence, p 17).

<sup>33</sup> With a base of 1974 = 100, the increase in money terms was 391.7 per cent and in real terms 49.95 per cent. Source: Department of Employment Gazette, April 1983. The data refer to the UK, not just England and Wales.

<sup>34</sup> Quarterly-billed consumers (primarily domestic and small commercial users) are charged by means of a tariff fixed normally once a year in April which includes a standing charge element and a rate per kWh for standard and off-peak tariffs (eg Economy 7). Industrial users are billed monthly and are subject to demand charges and the operation of a Fuel Price Adjustment (FPA) (formerly known as the Fuel Cost Adjustment), based on monthly variations in the national fuel price (with a base of £45.00/tonne in the 1983-84 BST).

(ii) *Brief Narrative of Events Leading to the Proposed Electricity Price Increase*<sup>35</sup>

27. Concurrently with the Monopolies and Mergers Commission Inquiry into the CEGB, the ESI undertook a review of the Bulk Supply Tariff (BST) in 1980–81, at the request of the Secretary of State for Energy, which was published in late 1981. In March 1982, the Department of Energy commissioned an independent investigation of the BST and alternative pricing structures by the accountants Coopers and Lybrand. Although this report had not been published when our enquiry began, it was made available to the Committee on a confidential basis.<sup>36</sup> Coopers and Lybrand raised questions about the assessment of Long Run Marginal Costs given the existing and projected surplus of generating capacity. In particular, they argued that the capacity cost element of LRMC should no longer reflect the cost of *new* capacity ("Net Effective Cost") but should primarily reflect the otherwise avoidable cost of maintaining *existing* generating plant in service ("Net Avoidable Cost"). This meant that the ESI's calculations of LRMC had been too high and, as a result, the Department of Energy took the view that the real price of electricity should be allowed to fall. Subsequently in November 1982, the Secretary of State announced that agreement had been reached with the industry that the average level of electricity prices should not increase in 1983–84.

28. Detailed discussions between the CEGB, the Electricity Council and the Department of Energy continued on the appropriate Financial Target for the two years 1983–84–1984–85. Whilst the Electricity Council had originally proposed a period of two years (given the difficulty of projecting the length and depth of the economic recession and future rates of inflation), the Council subsequently requested a Financial Target for a three-year period to provide greater stability in planning, a request with which the Government was unable to agree. Although there was insufficient time in which the ESI and the Government could resolve differing views on this and other points, on 18 March 1983 the Secretary of State set the ESI: (i) a new Financial Target of 1.4 per cent overall on average total net assets at current cost for the period 1983–84 to 1984–85, which was regarded as fully consistent with the standstill in prices in 1983–84; (ii) an EFL of minus £418 million for 1983–84;<sup>37</sup> and (iii) a Performance Objective to reduce controllable unit costs in real terms by 4.25 per cent over the Financial Target period.

29. According to the Electricity Council's Annual Report for 1982–83, published on 4 August 1983, all but one of the Boards had over-achieved their Financial Target for the three-year period ending in 1982–83. This led to complaints from the ECC and other organisations that prices had been set at too high a level. In addition, because of lower fuel costs and efficiency improvements, it became clear in Autumn 1983 that the ESI would over-achieve the Financial Target for 1983–84 and also appeared likely to achieve an estimated EFL of about minus £590 million compared with the figure originally set of minus £418 million. In September 1983, the ESI informed the Department of Energy that, if its preliminary assessment of the financial position was confirmed, the ESI would wish to hold the average level of electricity prices unchanged in 1984–85.

<sup>35</sup> See Department of Energy and Electricity Council memoranda, Evidence pp 3 to 5 and 10 to 13.

<sup>36</sup> The Government subsequently agreed, at the request of the Committee, to publish the Report, with the exception of 2 commercially sensitive paragraphs.

<sup>37</sup> Originally minus £300 million (Evidence, p 11).

In October 1983, the Electricity Council recognised that an overall *reduction* in tariffs in 1984–85 would be consistent with the Financial Target, but took the view that a small revision downwards would not provide electricity consumers with the correct message regarding longer-term movements in prices. On balance, it therefore concluded that the average level of prices should remain unchanged in 1984–85, even though this would result in an over-achievement of the two-year Financial Target.

30. These deliberations within the ESI coincided with the Government's consideration of the EFL for 1984–85. On 17 November 1983, the Chancellor of the Exchequer informed the House that an EFL of minus £740 million had been set for the ESI, in the light of the industry's trading position and investment requirements, judgments on LRMC and efficiency improvements and "*pressures on public expenditure*".<sup>38</sup> The Electricity Council had been informed of this decision in early November, and were advised that the Government considered that prices should be increased by 3 per cent in 1984–85.

31. At this time, the Council thought that there was a "reasonable prospect of achieving the EFL without a tariff increase"<sup>39</sup> and "considered it sensible to see how the position developed during 1984 before deciding what tariff increase, if any, might be necessary to achieve the EFL which the Government had imposed".<sup>40</sup> Subsequently, the Government asked the Electricity Council to consider increasing domestic tariffs by 2 per cent from 1 April 1984. On 19 January the Electricity Council agreed to recommend to Area Boards a 2 per cent increase in domestic tariffs and that monthly published tariffs would be subject to changes in the Fuel Price Adjustment. As yet the BST for 1984–85 has not been finalised and no discussions (other than on structure) have been held on it with the ECC under the terms of the Energy Act 1983. The retail tariff increases are currently under discussion at Area Board level including formal consultation with Area Electricity Consultative Councils.

(iii) *Evidence from HM Treasury*

32. The main thrust of the oral evidence presented to the Committee by the Treasury (Q1–84) was that the proposed 2 per cent increase from 1 April 1984 was justified by the need to maintain the price of electricity at an economic level. This concept was defined by a Treasury witness, echoing successive White Papers, as the need to ensure that prices "reflect the continuing cost of supply, including an adequate return on capital employed" (Q18 and Q41) and to "give the right signals to consumers" (Q7). Emphasising the importance of the economic pricing objective, the Treasury witnesses stated unequivocally that, so far as the Government were concerned, it enjoyed a higher priority than the Financial Target within the overall framework of controls and guidelines set for the nationalised energy industries. As one of the witnesses put it: "It is the pricing principle that is the important thing rather than the target" (Q9). Thus, despite the fact that pricing objectives were taken fully into account when the Financial Target was set in March 1983, it was in their view reasonable for the Government subsequently to propose a price increase to a nationalised industry which would cause it to exceed its target, especially if, as claimed by the Treasury (Q9), circumstances affecting the original pricing assumptions had altered in the meantime.

<sup>38</sup> Our emphasis. (Evidence, p 4).

<sup>39</sup> Evidence, p 13.

<sup>40</sup> Evidence, p 13.

In the words of a Treasury witness: "Events had changed, which meant that the Financial Target was going to be achieved without prices being set at what we felt were economic levels" (Q14). The Treasury stressed that a 2 per cent increase in domestic tariffs represented a decrease in real terms and that it was in any case a smaller rise than had been judged appropriate when the industry's financial target was set (Q36). The Treasury witnesses further argued that a small price increase early in the year was preferable to a larger one later (Q71).

33. The Treasury told the Committee that the External Financing Limit was intended to be the product of calculations and assumptions involving a number of other factors, including the appropriate level of economic pricing, and the industry's investment programme, Financial Target and Performance Objective. Of these it was economic pricing which was "the core of the decision" on the precise figure for the EFL (Q36). Questioned about the reason for the sharp increase in the 1984-85 EFL (minus £740 million, as compared with a figure of minus £418 million in 1983-84), the Treasury witnesses explained that the higher figure reflected improvements in the industry's cash flow position which had begun in the current financial year and were expected to continue into 1984-85. Chief amongst the factors leading to this improvement were a slippage in the investment programme (arising principally from delays in the Sizewell enquiry), lower than expected interest charges, and changes in working capital (Q25). The expected overshoot<sup>41</sup> of £172 million on the 1983-84 EFL had been taken into account in the fixing of the 1984-85 EFL, in the sense that the Treasury regarded it as justifying a more demanding figure for the coming financial year (Q28 and Q33). The Treasury denied that the higher EFL had been dictated primarily by the objective of raising revenue as part of the Government's policy of reducing the Public Sector Borrowing Requirement (Q8). Moreover, the witnesses argued, it was not true that the application of economic pricing principles invariably led to higher revenue for the Exchequer. A case in point was the decision to link to import prices the price for coal charged by the National Coal Board to the CEEGB.<sup>42</sup> This had the direct effect of reducing the NCB's revenue and thus of increasing the level of deficit grant paid by the Treasury (Q39 and 40).

34. Rejecting the assertion that the Treasury's view of economic pricing, and thus of the appropriate level of increase for 1984, had prevailed over that of the Department of Energy, the witnesses argued that the financial framework was a matter for discussion between the electricity industry, the Department of Energy and the Treasury and that any differences between Departments were reconciled by the Cabinet (Q15-21). Nevertheless, the Treasury had an overall responsibility for policy towards the nationalised industries in general, especially on pricing and investment, within the context of the need to promote the most efficient allocation of resources in the economy as a whole (Q1). It was bound also to take account of public expenditure considerations and the impact of the nationalised industries' claims on the PSBR (Q1).

<sup>41</sup> The term "overshoot" is used in this context to mean a *higher* than expected repayment to the Treasury. (The industry expects to achieve an EFL of *minus* £590 million in 1983-84, compared with a figure of *minus* £418 million originally fixed.)

<sup>42</sup> The effect of this might have been presumed to have reduced the marginal costs of coal (and hence of electricity) rather than to have warranted a price increase for electricity.

(iv) *Evidence from the Electricity Council and the CEBB*

35. The oral evidence from the Electricity Council and CEBB witnesses was intended to amplify the main factors underlying the decision of the Council on 19 January 1984 to recommend to Area Boards a 2 per cent increase in domestic tariffs from 1 April and to examine the implications for the future relationship between the Government and the electricity industry. A factual account of the main events leading to the Council's decision has already been given in paragraphs 27 to 31. In his oral evidence, Mr Jones, the Chairman of the Electricity Council, made clear that the decision had been taken only with reluctance (Q85) and that the Government's wish for greater confidence that the minus £740 million EFL, which had been "imposed" on the industry, could be met, had been "a very important factor" (Q89 and Q93). However, Mr Jones made clear that the proposed increase was necessary neither on economic pricing grounds nor in order to meet the industry's current Financial Target (Q85-88). The Chairman of the South Western Area Board added that a 2 per cent increase in domestic tariffs from 1 April would produce "a return double that which is required in terms of my financial objectives" (Q114). Mr Jones explained that the Electricity Council's Financial Target had been fixed in March 1983 "bearing in mind economic pricing" and only after "considerable debate" (Q87). According to the ESI's written evidence,<sup>43</sup> current prices (that is to say before the proposed 2 per cent increase), are already "equivalent to a broadly mid-point view on Long Run Marginal Costs under a surplus capacity situation". Moreover, during the time since the Financial Target had been set, as Mr Jones put it: "... the Treasury certainly have not talked to me or to any of my officers about economic pricing" (Q94).<sup>44</sup>

36. It emerged clearly from both the written and oral evidence by the ESI that once an EFL of minus £740 million had been, to use Mr Jones's word, "imposed" upon the industry (Q86), they would have preferred to await developments during 1984-85 before deciding whether a price increase was necessary. Indeed, in their written evidence, the ESI indicated that there was a "reasonable prospect of achieving the EFL without a tariff increase",<sup>45</sup> although Mr Jones was at some pains to emphasise the considerable uncertainties involved in such a judgment (Q104). In a supplementary note, the Electricity Council stated that the External Financing Limit consistent with the Financial Target would have been minus £380 million.<sup>46</sup> Mr Jones accepted that by implementing a price increase earlier than was strictly necessary in order to meet its Financial Target, the industry ran the risk of a relaxation in its own internal cost control discipline (Q128). More fundamentally, the way in which the Government had acted towards the industry was in direct conflict with the framework set out in the 1978 White Paper, which stated that the Financial Target should be the centrepiece (Q133). Instead, according to Mr Jones, the whole process had been inverted, with the result that the annual cash control mechanism of the EFL was being given priority over the medium term objectives, notably the Financial Target (Q133). The same point was reinforced by the Chairman of the South Western Electricity Board (Q113). In the view of the ESI witnesses, this state of affairs was inimical to the stability required by the nationalised industries for their efficient forward planning (Q134).

<sup>43</sup> Evidence, p 14.

<sup>44</sup> This statement appeared to be contradicted by the Secretary of State for Energy (Q244 and Q274-278). See also Appendix 5, para (iii).

<sup>45</sup> Evidence, p 13.

<sup>46</sup> See Appendix 4, para 5.

(v) *Evidence from the Consumers' Organisations*

37. The memorandum from the Electricity Consumers' Council (ECC),<sup>47</sup> as well as reflecting the general unease expressed in the Electricity Council's evidence, also raised a number of important specific matters. These included the apparent over-estimate throughout 1983 of the CEB's fuel costs (which account for about half of the industry's total costs);<sup>48</sup> the implications of a tariff increase given the industry's belief that its prices are already at the mid-point of the LRMC range; and the regressive effect of an increase in electricity charges compared with raising the same amount of revenue from direct taxation. The ECC also underlined the extent of the 1984-85 EFL's incompatibility with the ESI's Financial Target by claiming that the industry could probably absorb a rise in costs of 5 per cent in 1983-84 and still achieve its target without a price increase. The ECC pointed to the greatly enlarged negative EFL for 1984-85 as illustrating a trend over the last 4 to 5 years of steeply rising annual repayments of debt to the Treasury and contrasted this treatment with that accorded to other nationalised industries.<sup>49</sup> Regarding its own role, the ECC was anxious that the statutory consultation procedures should begin early enough, and with the provision of sufficient information, to enable the Consumers' Council to proffer its view before the industry's mind was irrevocably made up.<sup>50</sup>

38. The evidence from the London Electricity Consultative Council (LECC)<sup>51</sup> concentrated on two main aspects of the proposed tariff increase: the financial effects and the legal implications. On the first point, the LECC submitted to us, in addition to their Chairman's memorandum, a Report<sup>52</sup> commissioned by them on the financial effects over the period 1980-83 of the control framework for the London Electricity Board (LEB) (in relation to which the LECC is the statutory consultative body). The main findings of this Report are that: (i) the principal means used by the LEB to achieve its financial targets was to increase prices and thus profits, rather than to restrain costs; (ii) EFL's were set too stringently for the capital requirements of the industry in the context of its Financial Targets; and (iii) meeting the EFL took precedence over achieving the Financial Target, with the result that prices were driven higher than could be justified by costs and the LEB acted in effect as the collector of a surrogate tax on electricity consumers.<sup>53</sup> On the legal position, the LECC reported a Counsel's Opinion (commissioned by them) to the effect that the proposed price increase may cause individual Area Boards, and the LEB in particular, to be in breach of their statutory duties. (Under section 1(6)(b) of the 1947 Electricity Act, the Boards are required to "secure, as far as practicable, the development, extension to rural areas and cheapening of supplies of electricity", whilst the 1957 Act imposes a general duty on Boards to break even on revenue account, taking one year with another.) The LECC repeated the criticisms made by the ECC of the consultative procedures and stressed the need for the provision by the ESI of the fullest possible information at an early stage in the process leading to any tariff increase.

<sup>47</sup> Evidence pp 50 et seq.

<sup>48</sup> *ibid*, p 52.

<sup>49</sup> *ibid*, pp 56 and 57.

<sup>50</sup> *ibid*, p 51.

<sup>51</sup> Evidence, pp 57 et seq.

<sup>52</sup> Not printed in the Minutes of Evidence to this Report.

<sup>53</sup> Evidence, p 61.

(vi) *Evidence from the Secretary of State for Energy*

39. **The value of the oral evidence from the Secretary of State for Energy was greatly diminished by his rigid adherence to the doctrine of collective Cabinet responsibility.** This frustrated the Committee's legitimate attempts to establish the position originally taken up by the Department of Energy in the discussions with the Treasury both on the EFL for 1984-85 and on the level of price increase to be recommended to the Electricity Council. We were thus denied information about the differing perspectives of the Departments which in our view is essential to a proper understanding of the Government's position and the considerations which gave rise to it. This is particularly regrettable when many of the questions which the Secretary of State declined to answer have been the subject of extensive media discussion, the information for which can only have come directly from the principal Ministerial protagonists, either through the Lobby system or through individual briefings or speeches outside the House of Commons.

40. Throughout his evidence (Q225 to Q283) the Secretary of State maintained the defence that the proposed price increase was only a small one, that it represented a fall in real terms, that it was nevertheless justified on the grounds of economic pricing and that there was no question of the higher negative EFL having been dictated by macro-economic, ie revenue-raising, considerations.

(vii) *Conclusions on the Proposed Electricity Price Increase*

41. In reaching our conclusions about the proposed 2 per cent increase in domestic electricity tariffs from 1 April, we have been particularly influenced by two factors: the extent to which this decision is necessary on economic pricing grounds and the degree to which it accords with the industry's Financial Target. We have been struck by the unequivocal statements in the ESI's evidence (and that of the consumers' organisations) that the proposed increase is *not* needed in order to maintain electricity at an economic price. The industry believes that its current prices (ie *before* the proposed increase) are "equivalent to a broadly mid-point view on Long Run Marginal costs under a surplus capacity situation".<sup>54</sup> This excess capacity is likely to continue for the foreseeable future (as recognised in the Coopers & Lybrand Report, whose findings were used at least partly by the previous Secretary of State for Energy to justify a standstill in prices in 1983). Moreover, in view of the great uncertainties involved (which are acknowledged by the Treasury (Q14 and 41)), and the consequently wide band within which prices may be said to be consistent with LRMC's, it seems to us futile for the Government to intervene in order to fine-tune retail tariffs by relatively small amounts in order to maintain adherence to a purely theoretical principle of economic pricing.

42. In this sense, one of the main arguments used by the Secretary of State in defence of the price increase, namely that it is "only 2 per cent", serves merely to underline the pointlessness of the Government's action. Similarly, whilst a smooth pricing profile is in principle preferable to an uneven one (although this counts for less when relatively small percentages are involved), the contention that a "small" rise on 1 April is better than a larger increase subsequently, begs the question whether prices *would* otherwise need to rise by a significantly larger amount later in the year. We have certainly received no compelling evidence to support this assertion. Indeed, there is the countervailing argument,

<sup>54</sup> See para 27.

notably in the conclusions of the Coopers & Lybrand Report, which suggests that a continued fall in electricity prices in real terms could reasonably be expected over the short to medium term. The Electricity Council, in its memorandum,<sup>55</sup> confirmed that the figures most recently discussed with the Government related to price increases of 0 per cent in 1984-85 and 3 per cent in 1985-86 (assuming that the Financial Target continued at its present level into 1985-86).

43. So far as the Financial Target is concerned, none of the witnesses denied that a 2 per cent price increase would cause the industry to overshoot in 1984-85, following a probable significant overshoot in 1983-84. Since the Financial Target is supposed to be, in the words of the 1978 White Paper (repeated in the Treasury's evidence in 1981 to the TCSSC)<sup>56</sup> "central to the guidelines which the industries expect from the Government" and "essential for their short to medium term planning", the Government's intervention is particularly hard to justify, especially when the economic pricing argument rests on such shaky ground.

44. The Financial Target cannot be viewed separately from pricing policy, since the former is fixed taking the latter into account (Q88). Both the Treasury witnesses and the Secretary of State made much of the fact that the original Financial Target agreed with the industry had assumed a price increase for 1984-85 of some 1½ per cent below the rate of inflation (which on the basis of the then projections for inflation would have meant a 5½ per cent increase)—in other words *higher* than the one now proposed. We find it difficult to see the relevance of this argument to the present situation, in which the Electricity Council believes, almost a year after the Financial Target was set and in the light of the changed circumstances since then, that a 2 per cent price increase on 1 April is inconsistent with its Financial Target and is not required on grounds of economic pricing (Q89).

45. In short, neither in terms of the need for the industry to meet its Financial Target, nor on the basis of the Government's policy of economic pricing for electricity, are we persuaded by the case for a 2 per cent price increase on 1 April 1984.

46. The Chairman of the Electricity Council confirmed that the overriding reason for the decision to recommend the 2 per cent increase to Area Boards was to "give greater confidence" (to the Government) "of our ability to achieve the External Financing Limit of minus £740 million" (Q89). It cannot be stressed too strongly that, according to the Electricity Council, the industry is being required by the Government, through this EFL, to make a payment to the Treasury in 1984-85 of some £360 million over and above the figure of £380 million which would be consistent with the Financial Target. Mr Jones further made clear that the 1984-85 EFL was *not* an agreed figure and that it had been "imposed" on the industry without the normally expected degree of consultation. We find the whole process by which the EFL for 1984-85 was set, quite apart from the figure itself, extremely disturbing, since it appears to have almost completely inverted the normal procedure implied in successive statements of Government policy, notably in the 1978 White Paper, as well as in evidence to House of Commons Select Committees, including this one. Thus, instead of the EFL having emerged

<sup>55</sup> Evidence, p 12.

<sup>56</sup> Treasury and Civil Service Select Committee (HC (1980-81) 348-II); Evidence, p 44.

as the product of the industry's Financial Target, Performance Objective and commercial judgment on pricing, it appears in the words of the Chairman of the South West Electricity Board that the industry "is required to meet a certain EFL and [...] work backwards to see what tariff increase would be required in order to try and achieve that" (Q113). The Chairman of the Electricity Council reinforced this complaint, claiming that "there is a danger of annual cash controls being given priority over a proper Financial Target" (Q133). We fully agree with the Secretary of State's remarks in oral evidence: "If you started to use the EFL mechanism to go against the principle that evolved in Financial Targets, that would be wrong" (Q279). **We deplore the fact that these words have been contradicted by the Government's actions.**

47. We have already indicated our anxiety about the manner in which the EFL was imposed upon the industry. Nevertheless, it is a source of further criticism of the Government that, having fixed the EFL, they have been unwilling to allow the industry to decide for itself how best to meet it. This is all the more regrettable in view of the responsible and conciliatory position adopted by the Electricity Council in its evidence to us. The Council does not claim that a price rise could have been avoided altogether in 1984-85 but for the Government's intervention, although we note that in its memorandum, the Council sees "a reasonable prospect of achieving the EFL without a tariff increase".<sup>57</sup> In fact, the Council was asking for no more than to be allowed to see how the industry's financial position developed during the course of the year before deciding what action might be required.<sup>58</sup> **We find it quite extraordinary that the Government were unwilling to accept this sensible suggestion.** Moreover, no explanation for this attitude has been offered by the Government other than the vague and unsubstantiated assertion that without a price increase on 1 April "the industry might be taking too much of a financial risk" (Q242). It is also a matter of regret—especially in view of the cogent arguments in its memorandum—that the Council felt unable to stand by its original commercial judgment in this matter, although we appreciate the difficult position in which the Government's action had placed it.

48. The Government's unwillingness to trust the commercial judgment of the electricity supply industry in this way is bound to be damaging to morale, not least because it ignores the industry's commendable record over recent years in achieving or exceeding the various targets laid down in the financial framework.<sup>59</sup> It is particularly perverse in the light of the expected overachievement of £172 million in the current year's EFL.<sup>60</sup> **However, the effect of the Government's action is even more retrograde in terms of general policy towards the nationalised industries, since it obliges the electricity industry, against its own better judgment, to adopt the pricing policy of an unfettered monopoly producer, when the Government's declared aim is to restrain costs by introducing a greater element of competition into the energy market through such measures as the Energy Act 1983.**

<sup>57</sup> Evidence, p 13.

<sup>58</sup> *ibid.*

<sup>59</sup> Evidence, p 18.

<sup>60</sup> See para 29.

49. Despite the strenuous denials of the Treasury witnesses, we cannot avoid the conclusion that the only plausible motivation for the large increase in the ESI's negative EFL for 1984-85 (which has led directly to the decision to recommend a 2 per cent price increase from 1 April) was the Government's wish, on grounds of macro-economic policy, to raise additional revenue in order to reduce the Public Sector Borrowing Requirement. We note that the recently published White Paper on Public Expenditure (Cmnd 9143-I) projects a decline in the total external financing limits for all nationalised industries from £2.5 billion in 1983-84 to only £90 million in 1986-87. Given the very large combined funding requirements of the coal and railway industries, which seem, in the absence of major policy changes, likely to fall only slowly if at all during the period in question, this may indicate that, even allowing for the effects of privatisation, continued and sharply rising contributions to the Exchequer will be expected from the profit-making gas and electricity industries. The implications of this for increased prices over the next 3-4 years could be significant, even if further substantial improvements in efficiency are achieved. It is not for the Energy Committee to express a view about the merits of this aspect of the Government's economic policy. So far as the chosen method is concerned, we would merely observe that the principle of using energy as a source of revenue has to some extent been established through the imposition of PRT, excise duty and VAT on petrol and other oil products and, more recently, through the Gas Levy. The Secretary of State confirmed this view in his evidence (Q283). A counter-argument, advanced by the Electricity Consumers' Council in its memorandum, asserts that using electricity as a source of revenue is likely to be socially and economically regressive compared with a policy of raising the equivalent yield from direct taxes.<sup>61</sup> We have not taken sufficient evidence during this enquiry to enable us to comment on this point.

50. A far more effective means of increasing the Government's revenue from the electricity industry, if that is desirable, would have been to set a new, and higher, Financial Target (together with an EFL consistent with it), and at the same time to ensure through the Performance Objective that these were met largely from increased efficiency rather than higher prices. If, however, the Government decides that it is necessary, on revenue-raising grounds, to require the electricity industry to increase its prices in order to ensure that its greatly enlarged negative EFL can be met, then this should be openly and honestly avowed. The Treasury should not seek to cloak a largely fiscal policy decision in the impenetrable garb of economic pricing jargon.

51. The Treasury witnesses did not strengthen their case by the manner in which they chose to present it to the Committee. An honest statement of the constraints placed upon their freedom to speak would have been more acceptable than the disingenuous claim that they knew no more about the Electricity Council's views than they had read in the newspapers (Q16, Q17). The inability of the Treasury to present their own case in a cogent and serious manner can only encourage the assumption that they do not themselves believe that it would survive close scrutiny.

<sup>61</sup> Evidence, p 55.

52. There are two other aspects of the proposed increase, upon which we are not in a position to comment, but which we hope the Government and the industry will take very seriously. The first, raised by the ECC in its memorandum, concerns the apparent overestimate, throughout 1983, of the CEGB's fuel costs. **We recommend that the Electricity Council take up this matter and discuss its implications for future tariff levels with the ECC, having first provided the ECC with the information requested in its memorandum.**<sup>62</sup> Secondly, we hope that both the industry and the Government have considered carefully the legal questions raised in the memorandum from the London Electricity Consultative Council. It is not for us to comment on the merits of these arguments, nor are we competent to do so. Nevertheless, the implications for relations between Government and the nationalised energy industries are potentially so far-reaching that, at the very least, the LECC deserves a full answer to the points it has raised. **Accordingly, we recommend that the Government and the industry publish a joint response to the legal aspects of the LECC's submission to this Committee.**

53. We would summarise our conclusions on the proposed electricity price increase as follows. It is not justified on the grounds either of the industry's Financial Target or the Government's economic pricing policy. The only plausible reason for it is the Government's desire to raise additional revenue for macro-economic purposes. This being the case, the Treasury should have the honesty to say so, rather than retreating behind a smokescreen of economic pricing. Finally, the manner in which the 1984-85 EFL was imposed on the industry is in conflict with the agreed framework within which the Government and nationalised industries are supposed to operate.

#### ***IV: THE IMPLICATIONS FOR THE FUTURE: THE FINANCIAL AND CONSULTATIVE FRAMEWORK FOR THE GAS AND ELECTRICITY INDUSTRIES***

54. At the outset of this enquiry we posed a number of questions<sup>63</sup> relating to the processes by which the decisions on the recently announced increase in gas prices and the proposed increase in electricity prices were reached. It will be clear from our conclusions in sections II and III of this Report that we believe the answers to these specific questions to be very unsatisfactory, particularly in the case of electricity. However, there are also a number of general conclusions to be drawn, which we believe have important implications for the future relationship between the Government and the industries concerned and between the industries and the consumers' organisations.

##### ***(i) The Financial Target***

- 55.(a) **We believe that the Financial Target, as laid down in the 1978 White Paper, should be the main mechanism of control by which the gas and electricity industries are required to operate;**
- (b) **It should be agreed with the industries and published before the start of the first financial year of the period to which it applies;**

<sup>62</sup> Evidence, pp 52 and 53.

See paragraph 7.

- (c) It should be set at a demanding level and for as long a period as possible, preferably at least the 3 years envisaged in the White Paper, in order to provide the stability which the industries require for their short to medium term planning;
- (d) As a matter of general principle, Financial Targets should not be overridden by the annual cash control mechanism of the EFL.

(ii) *Performance Objectives*

- 56.(a) Performance objectives should be set which have the effect of exerting steady downward pressure on costs, whilst allowing for those elements in the cost structure outside the industries' control (eg the rising cost of new contract supplies of gas);
- (b) in conjunction with the Financial Target, the Performance Objective should be the main yardstick by which the efficiency of an industry is judged;
  - (c) it therefore makes sense, where possible, for Performance Objectives to be set for the same period as the Financial Target.

(iii) *The External Financing Limit*

- 57.(a) The EFL, which is designed as a short-term (annual) cash control mechanism, should be set at a level consistent with the Financial Target; the exact figure should emerge as the product of the Target itself (which incorporates assumptions on pricing), the industries' capital investment requirements and the Performance Objective;
- (b) it should not be changed during the course of the financial year, save in exceptional circumstances and subject to the approval of Parliament;<sup>64</sup>
  - (c) it should be a figure agreed with the relevant industry after proper consultation, as laid down in the 1978 White Paper.

(iv) *Pricing Policy*

58. We believe that the term "economic pricing" is so confused, vague and uncertain in its application by the Treasury to different nationalised energy industries, as to be virtually meaningless. If the term is to have any value, it ought to be possible to define it with sufficient precision to enable the range of prices resulting from its application to be properly quantified and published. No such precision has been forthcoming in the evidence presented to us. We believe the following considerations to be relevant in arriving at a rational energy pricing policy:

- (a) While fuel prices should obviously have some regard to the cost of supply on a continuing basis, LRMC's can only be one factor in a range of relevant considerations, since they are subject to large margins of forecasting error and depend on a variety of uncertainties and assumptions.<sup>65</sup> This was made clear by our predecessors in their Report in 1981.<sup>66</sup>

<sup>64</sup> A similar proposal was made both in the Second Report from the Committee of Public Accounts (1983-84) HC 139 and in the First Report from the Select Committee on Procedure (Finance) (1982-83) HC 24.

<sup>65</sup> In a supplementary memorandum (Appendix 4) the Electricity Council states that its current assessment puts the range of views on LRMC in a surplus capacity situation at about plus or minus 5 to 10 per cent around the average price in 1984-85 of 4.7 p/kWh (ie 4.23 to 5.17 p/kWh).

<sup>66</sup> Second Report (HC (1980-81) 422-1) on "Industrial Energy Pricing Policy".

- (b) To promote the widest possible debate and consultation between all the parties to pricing decisions, and to encourage clarity in pricing policy, the Government should publish the full range of its LRMC calculations, since it is at present unclear whether electricity consumers, for instance, should expect prices to fall or to rise over the foreseeable future within a wide margin of 20 per cent.<sup>67</sup>
- (c) the commercial judgment of the energy industries about the appropriate tariff levels for their products should be accorded great weight in discussions with Government about pricing policy. Commercial judgments should not be over-ridden or unnecessarily circumvented without the fullest explanation to Parliament and the public as to why such a step needs to be taken.

(v) *The Role of the Consumers' Organisations*

59. It is clear that if the statutory processes of consultation are to have any purpose at all, the consumers' organisations must not be placed in the position of having to react to a fait accompli. They should be invited to give their comments on proposed price increases at a sufficiently early stage to have some genuine chance of influencing the outcome. Moreover, if the spirit as well as the letter of the consultation process is to be fulfilled, consumers' organisations must have access to the maximum relevant information to enable them to reach a considered judgment. In this regard, only the strictest interpretation of commercial confidentiality should be regarded as a legitimate justification for withholding information. The problems inherent in granting the consumers' organisations statutorily enforceable powers over pricing decisions seem to us to be insurmountable, since in practice this could only mean a veto or a right of delay. This could create uncertainties, which, in extreme cases, might render the industries unmanageable. However, there is no reason why, if the principles set out in this paragraph are applied, these organisations should not play a full part, on behalf of the consumer, in providing some check on the pricing decisions of nationalised energy industries and in monitoring their efficiency. The real problem arises where, as in the case of electricity this year, the Government overrides the commercial judgment of an industry and obliges it to make an unwanted price increase. The consumers' organisations are then put in an impossible position in which they are required to react to a proposal which is only nominally the result of a decision by the industry concerned but which in reality has been imposed by the Government at one remove. It will be clear from our earlier remarks that we do not believe the Government should interfere in this way.

(vi) *The Need for a Coherent Statement of Government Policy Towards the Nationalised Energy Industries.*

60. In setting out our views on the future relationship between Government and the nationalised energy industries we are doing little more than restating the main principles which had always been assumed to underlie the 1978 White Paper and which had been endorsed as long ago as 1968 by the Select Committee on Nationalised Industries.<sup>68</sup> As the Chairman of the Electricity Council put it: "it [the 1978 White Paper] was certainly welcomed by the Electricity Supply

<sup>67</sup> We are glad that the Government, in response to the Committee's suggestion (Q266 to 272), have agreed to publish the Coopers and Lybrand Report (see paragraphs 27 and 41), subject only to the deletion of 2 commercially sensitive paragraphs.

<sup>68</sup> HC (1967-68) 371-I.

Industry and I think by every nationalised industry. I think if you take any nationalised industry they would say what I am saying: 'Please let us have a consistent and coherent financial framework' " (Q134). (Similar sentiments were expressed by the BGC (Q161)). This seems to us to be the very least which the industries are entitled to expect of Government. However, we believe, in view of the confusion and inconsistencies in the application of the financial framework to the industries which have emerged during the evidence on the gas and electricity price increases, that there is an urgent need for the Government to clarify its policy in this area. This should preferably take the form of a reaffirmation, in comprehensible layman's language, of the principles set out in the 1978 White Paper.

## APPENDIX A

### *THE FRAMEWORK OF FINANCIAL CONTROLS OF THE NATIONALISED ENERGY INDUSTRIES*

#### *(i) The Evolution of Statutory and Other Controls*

61. The nationalisation statutes of 1947-8 charged the industries concerned to balance their books taking one year with another, after paying interest and making due allowance for depreciation; the approach was that of average cost pricing.

By 1960 there was mounting concern about the possibility of state "monopolies" being divorced from market disciplines and making inadequate returns on investment.

In 1961, the Government introduced a system of financial objectives under which each nationalised industry was set a financial target, usually a rate of return on its capital assets.<sup>69</sup>

In 1967, the Government reinforced the principle of financial targets, stipulated that a Test Discount Rate should apply to all new investment by the nationalised industries, and that their pricing should be based on Long-Run Marginal Costs (LRMC).<sup>70</sup>

In 1978 these principles were further upheld<sup>71</sup> and they were reinforced by the introduction of performance targets, and the application of cash limits, subsequently referred to as External Financing Limits (EFL).<sup>72</sup>

Thus between 1961 and 1978 there was a progression to a more comprehensive, though non-statutory, framework of controls, embracing not only those instruments which govern all aspects of the pricing and financial regime of the nationalised industries, but also the regular annual review of their operating performance and investment plans by their sponsoring Departments and the Treasury. The basic principle was that all the various elements were meant to be mutually consistent and that the prime determinant of pricing should be the estimation of LRMCs.<sup>73</sup> The principles underlying the financial framework were restated as recently as 8 February 1984 in a Parliamentary written answer.<sup>74</sup>

<sup>69</sup> 1961 White Paper Cmnd 1337.

<sup>70</sup> 1967 White Paper Cmnd 3437.

<sup>71</sup> 1978 White Paper Cmnd 7131.

<sup>72</sup> 1975 White Paper on Cash Limits, Cmnd 6440.

<sup>73</sup> See also Treasury and Civil Service Committee Evidence (HC (1980-81) 348) and Energy Committee, 2nd Report (HC (1980-81) 422).

<sup>74</sup> Hansard, 8th February 1984, Written Answers, col 592.

(ii) *The Constituent Parts of the Framework*

62. *Long Run Marginal Cost Pricing*: this is an economic concept which argues that prices should be determined by the costs of meeting additional demand on a continuing basis, including the capital components, taking into account both long and short-run market factors; it is designed to simulate the desirable effects of competitive pricing, recognising that a *perfectly* competitive market would probably generate prices based on LRMCs through the operation of market forces.<sup>75</sup> The present Government has pursued "economic pricing" which, as regards electricity, was defined by the then Secretary of State for Energy on 3 November 1980 as "pricing according to long-run marginal costs".<sup>76</sup>

63. *The Financial Target*: this is the primary instrument of control in the medium term. It should be based on discussion with the industries, and reflect a judgment about the application of the basic principles set out in the 1978 White Paper<sup>77</sup> to the particular trading environment over the target period. This period is generally 3–5 years and the Target is normally expressed as a percentage return on net or gross assets. The present Financial Target for the electricity supply industry (ESI) in England and Wales is 1.4 per cent for 1983–84 to 1984–85, and that the BGC is 4.0 per cent for 1983–84 to 1986–87, both measured in terms of average total net assets at current cost. In the case of the ESI, each Area Board and the CEGB have their own Financial Target, which is consistent with that for the industry as a whole.

64. *The Performance Objective*: the present Performance Objective for the ESI as a whole is to reduce controllable unit costs by 4.25 per cent (ie a reduction in real unit costs) in the period 1983–84 to 1984–85 compared with 1982–83.<sup>78</sup> For the BGC, it is to reduce controllable unit costs by 12.0 per cent in 1983–84 to 1986–87 compared with 1982–83 (ie a reduction in real net trading costs per therm of gas sold).<sup>79</sup> A Performance Objective was not set for the ESI prior to that currently in force, and the target is not set for individual Boards. The previous Performance Objective for the BGC was for a 5 per cent reduction in unit net trading costs per therm of gas sold in 1982–83 compared with 1980–81, with costs measured in 1980–81 prices and gas sales converted to seasonal normal temperatures. In fact the BGC achieved a 5.1 per cent reduction.<sup>80</sup>

65. *The External Financing Limit*: this is an instrument of short-term control of public sector borrowing; for the electricity and gas industries, which are self-financing in terms of their investments, it exerts a sustained control on the net financial inflows and outflows of the nationalised industries, primarily to the Exchequer.<sup>81</sup> The limit applies to a single financial year only and is supposed to complement the medium term Financial Targets. If all elements of the financial framework are mutually consistent, then the EFL will equal the difference between the gross incoming and outgoing flows of cash of the industry concerned, as defined in Table 4, so as not to necessitate a price increase. EFLs may be

<sup>75</sup> Second Report from the Energy Committee, Session 1980–81, Appendix 25.

<sup>76</sup> Hansard, 3rd November 1980; Evidence, p 13.

<sup>77</sup> Cmnd 7131, paras 69–78.

<sup>78</sup> For further details see Evidence, p 20.

<sup>79</sup> Evidence, p 30.

<sup>80</sup> *ibid.*

<sup>81</sup> For a Table showing the EFL's of all the nationalised industries, see Evidence, p 57.

positive or negative, the former indicating an increase in the industry's net borrowing and the latter indicating a net payment by the industry (a reduction in debt for those industries with outstanding debt, such as electricity). According to the Treasury, a negative EFL is the public sector equivalent of a dividend for an industry with no outstanding debt—at present only the BGC is in this position (Q59). Much of the present controversy over the proposed electricity price increase relates to differences of view regarding the consistency between the ESI's financial target and EFL.<sup>82</sup>

TABLE 4

*Sources and Applications of the Electricity Supply Industry's Funds*

|                      | <i>Item</i>                                                          | <i>Comment</i>                        |
|----------------------|----------------------------------------------------------------------|---------------------------------------|
|                      | Income from electricity sales                                        | pricing principles relevant           |
| less:                | total expenditure on revenue account                                 | performance aim relevant              |
| equals:              | operating profit                                                     | financial target agreed by Government |
| less:                | interest payments                                                    |                                       |
| plus:                | depreciation                                                         | related to current value of assets    |
| plus:                | other provisions and miscellaneous capital receipts                  |                                       |
| less:                | capital investment                                                   | approved by Government                |
| plus<br>or<br>minus: | changes in working capital (mainly fuel stocks and unbilled revenue) |                                       |
| equals:              | external financing requirement repayment                             | EFL agreed by Government              |

Source: *Electricity Council memorandum*, p 2.

## APPENDIX B

### THE COMPARATIVE CAPITAL DEBT POSITIONS AND COST PROJECTIONS OF THE GAS AND ELECTRICITY INDUSTRIES

#### (i) *The Gas Industry*

66. The largest element in the BGC's costs is the purchase of gas from the North Sea, the average cost of which rose from 5.8p/therm in March 1979 to 14.8p/therm in March 1983 (ie an increase of 155 per cent over the four years); the Gas Levy represented 3.2p/therm, or over a third of the increase. As stated in paragraph 14, the BGC is currently paying 24p/therm for Norwegian Frigg gas, 7p/therm above the average cost of all its gas supplies—including the Gas Levy. Although the trend in the cost of new supplies needed to replace existing low-cost supplies is rising, the BGC expects that many of its future supply sources will be less expensive than Norwegian Frigg gas. The current Performance Objective requires the BGC to reduce its net trading costs (the totality of its onshore costs associated with gas transmission and distribution) by 12 per cent on a per therm basis *in real terms* by 1986–87 compared with 1982–83. To the extent that this is achieved, it will moderate the overall increase in future costs and

<sup>82</sup> See Section III of the Report.

hence the need for future price increases. Whereas the figures in the report by Deloitte, Haskins and Sells relate to 1982-83 and suggest that gas prices were some way below the LRMC level in all markets, the BGC's own later calculations put the long-run marginal cost (including a 5 per cent return on new investment) in the range of 31-36p/therm, which encompasses the present average price.<sup>83</sup> The BGC expects that both domestic and industrial gas price increases over the next two to three years will be close to the general level of inflation.

67. Like the ESI, the BGC finances the whole of its investment requirements from its own resources. The Corporation argues that this is in the longer term interest of consumers because it avoids the high cost of borrowing (Q174). Unlike the ESI the BGC has not only repaid its entire previous capital borrowings from the Exchequer but it has deposited £300 million on ten year terms with the National Loans Fund. The BGC's EFL for 1984-85 is minus £100 million, but the Corporation states that broad agreement has been reached whereby the EFL for 1985-86 will be minus £390 million and that for 1986-87 will be minus £490 million. According to the Treasury, the BGC's EFL of minus £100 million for 1984-85 will be met by a repayment of market and overseas borrowing (£14 million), net public sector temporary deposits (£85 million) and reduced leasing (£1 million); the placing of the temporary deposits will be at the BGC's commercial discretion and they will earn interest.<sup>84</sup>

(ii) *The Electricity Supply Industry*

68. The ESI as a whole is currently self-financing, and it expects its capital requirements will be entirely financed from internal sources (primarily from current cost depreciation) over the period 1983-84 to 1989-90. However, unlike the BGC, the ESI as a whole does not expect to have repaid all of its outstanding capital debt of some £4 billion until 1988-89 (see Table 5). The position of the statutorily independent Area Boards varies considerably, some of the Boards expecting to clear their debts much more rapidly than others over this period.

Table 5

*Debt Reduction Prospects of ESI*

| <i>Expected Balance of Borrowings at Year End (£m)</i> |     |     |     |     |         |
|--------------------------------------------------------|-----|-----|-----|-----|---------|
| 1983-84...                                             | ... | ... | ... | ... | 4337    |
| 1984-85...                                             | ... | ... | ... | ... | 3941    |
| 1985-86...                                             | ... | ... | ... | ... | 3318    |
| 1986-87...                                             | ... | ... | ... | ... | 2431    |
| 1987-88...                                             | ... | ... | ... | ... | 1244    |
| 1988-89...                                             | ... | ... | ... | ... | (-)96   |
| 1989-90...                                             | ... | ... | ... | ... | (-)1589 |

Source: *Medium Term Development Plan, 1983-90*, Electricity Council, June 1983, para 37.

69. Notwithstanding the industry's own review of the Bulk Supply Tariff and the subsequent examination by Coopers and Lybrand, it has become apparent that there remains a difference of view between the industry, the Department

<sup>83</sup> See Appendix 6.

<sup>84</sup> See Appendix 3.

of Energy and the Treasury about future cost expectations. As explained in paragraph 27, the immediate effect of the review of the BST and of LRMCs was a decision by the Government that the real price of electricity should be allowed to fall. Consequently, the average level of prices remained fixed (a fall of some 5 per cent in real terms) in 1983–84 and the proposed 2 per cent increase for 1984–85 is expected to represent a real reduction of 3 per cent (against an assumed increase in the RPI of 5 per cent over this period).

70. As the Department of Energy's memorandum makes clear, it is not possible to predict with any certainty the appropriate level of electricity price increases in subsequent years. Future price increases will be influenced by the new Financial Targets and EFL to be set for 1985–86, as well as by movements in fossil fuel prices and labour costs. However, the Government takes the view that electricity prices are likely to rise more slowly than those for gas<sup>85</sup> and, as stated in the Department of Energy's memorandum, "there are good prospects that the increase will be below the rate of inflation again in 1985–86."

71. The Committee has been struck by the way in which witnesses, whilst stressing the belief that LRMC's contribute to efficient resource allocation within the economy, were reluctant to quantify them in anything other than vague terms. The ESI stated in their memorandum that "for the time being, the industry is reasonably satisfied that present prices are equivalent to a broadly mid-point view on LRMC under a surplus capacity situation".<sup>86</sup> They added that "within this broad equivalence, however, the over-estimation of fuel costs in particular over the last two years has led to quarterly tariffs being a little higher in relation to the cost assessments than are monthly tariffs which have fuel price adjustment clauses".<sup>87</sup> Thus, if charges of undue preference are to be avoided, it is realistic to anticipate that quarterly tariff consumers (primarily domestic) may expect slightly smaller increases than industrial, monthly-billed consumers.

<sup>85</sup> Evidence, p 4.

<sup>86</sup> The Treasury appeared to agree with this view (Q41).

<sup>87</sup> Evidence, p 14.

MINUTES OF PROCEEDINGS RELATING TO THE CONSIDERATION OF THE  
REPORT

TUESDAY 14 FEBRUARY 1984

Members present:

(Mr Ian Lloyd, in the Chair)

Dr Michael Clark  
Mr J. D. Concannon  
Mr Ted Leadbitter  
Mr Geoffrey Lofthouse

Mr Gerald Malone  
Mr Michael Morris  
Mr Peter Rost  
Mr Tony Speller

The Committee deliberated.

[Adjourned till Tuesday, 21 February at Four o'clock.

TUESDAY 21 FEBRUARY 1984

Members present:

(Mr Ian Lloyd, in the Chair)

Mr Kevin Barron  
Dr Michael Clark  
Mr J. D. Concannon  
Mr Robert Hayward

Mr Ted Leadbitter  
Mr Geoffrey Lofthouse  
Mr Gerald Malone  
Mr Peter Rost

The Committee deliberated.

Draft Report (Electricity and Gas Prices), proposed by the Chairman, brought up and read.

*Ordered*, That the proposed Report be read a second time, paragraph by paragraph.

Paragraph 1 read and agreed to.

Paragraph 2 read, amended, and agreed to.

Paragraphs 3 to 11 read and agreed to.

Paragraph 12 read, amended, and agreed to.

Paragraphs 13 to 36 read and agreed to.

Paragraph 37 read, amended, and agreed to.

Paragraphs 38 to 48 read and agreed to.

Paragraphs 49 and 50 read, amended, and agreed to.

Paragraphs 51 to 66 read and agreed to.

Paragraph 67 read, amended, and agreed to.

Paragraphs 68 to 71 read and agreed to.

Summary of Conclusions and Recommendations read and agreed to.

Several papers were ordered to be appended to the Minutes of Evidence.

*Ordered*, That this be the First Report of the Committee to the House.

*Ordered*, That the Chairman do make the Report to the House.

*Ordered*, That the provisions of Standing Order No 92 (Select Committees (Reports)) be applied to the Report.

[Adjourned till Thursday, 23 February at Four o'clock.